QUARTERLY COMMENTARY

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Containing the Contagion

The late Marty Zweig is credited with saying, "Don't Fight the Fed". In his book, *Winning on Wall Street*, published in 1970, he writes, "indeed the monetary climate - primarily the trend in interest rates and Federal Reserve policy – is the dominant factor in determining the stock market's major direction." This has been proven time after time, and is doing so once again. Despite a record plunge in employment in the U.S. and Canada, and another surge in jobless claims in the U.S., the markets have recovered a whopping 55% of their losses in short order. And this, after the most brutal downturn in history – the fastest decline into a bear market ever, dropping over 20% in just 16 trading sessions. It's almost like a beach ball that's been put under water and when your hands release it, it just flies right back up. This return to some degree of potential normalcy in the markets has been swift.

As I have written many times in these reports, no one can accurately predict the short term direction of the markets. This is simply because things can and do change very quickly. The Federal Reserve announced another series of steps that will provide as much as $2.3 trillion in additional aid, giving help to small and mid-sized businesses as well as state and local governments and the markets have had a substantial turn as a result. Fed Chair Powell does not want to go down in history as the guy who let the world's economies tank into a 1930s-style Great Depression. "We will continue to use these powers forcefully, proactively, and aggressively until we are confident that we are solidly on the road to recovery", he said.

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Last week was the best week since 1974 for the S&P 500. In the 1973/74 recession the market went down 50%. Why do we keep hearing best days or weeks since.... referring to 1933, 1974, 1987 or 2008? These are periods of extreme market volatility and in three of the four time periods, the economy was in a recession. With the latest jobs data and unemployment, it’s clear we are in a deep recession. Not only in North America, but the world. Does the market rally before the end of the recession? – Yes. Was last week’s powerful rally the beginning of a ‘new bull market’? – It’s possible, but unlikely. After this recovery of 55% of the market drop, we will most likely encounter resistance to move much further above this area. Recessions tend to last longer than eight weeks and I’m pretty sure that this one will last longer than the average. We are in unprecedented times and the markets also reflect our emotions. I would describe the latest surge as a relief rally.

Markets are forward looking. So when news is bad — but less bad —, that will be a positive for the stock market. And what we've seen on the health care side of this crisis is that while the headlines are still jarring, at the margin they're improving. And with some of the latest forecasts that have been put out by New York and here in Ontario and elsewhere, we can now start to see when the crisis might be contained and when things will be much better. That has been the other major driving factor for the markets in the last few weeks. As an aside, I have heard that an effective convalescent plasma therapy is being quickly developed using the antibody-rich blood plasma of COVID19 survivors to be used for very ill patients which should significantly reduce this horrible disease’s mortality rate.

A big question is will the markets retest the March 23 lows. Everything depends on the length of the disruption from this pandemic. But if things improve significantly by June, after these massive rounds of fiscal and monetary stimuli, a retest will be less likely. There is no question that there will be more pain to come for the economy, but markets at one point were pricing in the worst, with no clarity as to how this crisis will end.

Starting the second quarter, the near term picture for the economy is indeed dismal – estimates vary but some anticipate as much as a 40% decline in GDP and an unemployment rate of around 20%. That will be fleeting though – probably just for a few months. Paradoxically, the shockingly high numbers of jobless claims can even be viewed as helpful to the market, as they increase political pressure on Congress to scale up rescue measures even beyond the $2.3 trillion legislation already enacted. With regards to corporate earnings – forget about it. We'll see many companies reporting their earnings that won't just reduce their forecasts but do away with them altogether.

What we are always trying to do is to maximize the return potential relative to the risks that we see and that's definitely the task at hand today. Think about this crisis in two ways. The first, from the health care front, is to understand how the number of cases could peak and what that scenario looks like. And with each passing day, I think we have a better idea about how that looks. The next question that will be very important to determine if this recent market strength is sustainable is: when will the economy reopen and how profitable will it be when it reopens? On the economy - when could the economic output look similar to what it's looked like in the recent past? No-one expects that the economy is going to bounce back immediately to the level it was performing at before this event. Perhaps it's not until mid or late 2021, or even 2022. What will happen though is the markets will anticipate this well before it actually occurs and that's why it's important to make sure that your portfolios are positioned for the next leg up over time.

Right now financial markets are betting that there is some reasonable approximation of normal on some foreseeable horizon - that widespread job losses and drops in income won't cause the mass closure of businesses. That people will have a job to go back to and will be willing to spend when the public health crisis ebbs. What it comes down to is a question of time. How many businesses will be pushed into bankruptcy before life returns to semi-normalcy? How long and deep will this recession be—and how difficult the recovery—depends on how long we keep the economy in this kind of artificially induced coma. If we can gradually reopen the economy over the course of May, with some acceleration of activity in June, the damage could be limited, particularly if the government keeps providing support to households and businesses. Over the next two or three weeks, the priority should be to identify a strategy to restart economic activity while maintaining sufficient precautions to safeguard public health. If we wait much longer though, the recession will acquire its own momentum and our ability to engineer a recovery will be a lot more limited.

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If there is one thing I'm certain about, it's that predicting the future is a very difficult task as evidenced by this black swan event we're all living with today. All the predictions for the next couple of quarters on what the market bottom will look like – whether it will be a V-shape, W-shape, U-shape, L-shape – pick a letter – are just guesses. Regardless of the prediction, buying good-quality companies during good times as well as bad is one of the easiest ways to make the guess work irrelevant.

If you have any questions about your portfolio or any changes you would like to discuss, please don't hesitate to contact my office at any time.

Sincerely,

Richard